Introduction to Conflicts of Interest

A savings association providing trust and asset management services to fiduciary accounts may face a variety of conflict of interest situations. Conflicts of interest generally occur due to the inherent differences between the institution's own interests and the interests of its fiduciary customers. As a fiduciary, a savings association has two primary duties to its customers: loyalty and prudence. In accordance with its duty of loyalty, it must always place the interests of its fiduciary customers first. This requires making decisions concerning the investment and management of trust assets based exclusively on the best interests of the trust account. When acting in a fiduciary capacity it should not place itself in a position in which its interests (or those of its subsidiaries or affiliates) conflict with those of trust customers. For instance, if a savings association has investment discretion for a fiduciary account and decides to use its own products or services or those of its subsidiaries or affiliates, it faces a conflict of interest situation.

A savings association also has a duty of prudence with regard to the fiduciary accounts for which it has investment discretion. The common-law duty of prudence requires a fiduciary to exercise the reasonable care and skill a man of ordinary prudence would exercise in the investment of his own assets, taking into consideration the preservation of the estate and the amount and regularity of income to be derived. This is known as the "prudent man" rule. Under the "prudent man" rule, a fiduciary generally will look at the investment of account assets on an individual asset basis. In an increasing number of states, the prudent man rule has evolved into the "prudent investor" rule. The "prudent investor" rule emphasizes the importance of overall risk management and looks to the diversification of the entire portfolio of trust account investments, without arbitrarily excluding any individual asset.

OTS takes the position that a savings association may engage in an action on behalf of its fiduciary accounts that otherwise would be a conflict of interest if the action is authorized by applicable law (i.e., the governing trust instrument, applicable federal or state law or court order) or, absent any prohibition, if all the beneficiaries consent after full disclosure. Obtaining the consent of all the beneficiaries may be difficult if more than one class of remaindermen exist or if the beneficiaries are minors, unborn, or otherwise unable to give informed consent. Under applicable state law, the savings association may need to have a guardian ad litem appointed for minors, the unborn, or the incompetent and obtain an order from the appropriate court approving the transaction.

OTS does, however, acknowledge that some states have enacted virtual representation statutes that may allow, under certain circumstances, the current beneficiaries of a trust to bind future beneficiaries. If a savings association is attempting to gain consent of all the beneficiaries of a trust in order to approve a conflict of interest transaction under such a statute, it should first obtain a well-reasoned opinion of counsel. That opinion should address whether the state statute applies in these circumstances, as well as whether all the provisions of the statute have been met. In any case, the savings association must fully and completely disclose the details surrounding the conflict in order for consent of all the beneficiaries to overcome the conflict.

If a savings association pursues an investment for a trust account for which it has discretion that presents a conflict of interest, but which applicable law authorizes, the trustee has not necessarily complied with the duty of prudence with respect to that investment. Good risk management practices require the savings association to document its decision making process in determining that an investment meets the prudence requirements of the applicable state statute.

The grantor of a revocable trust can direct the fiduciary to conduct otherwise impermissible transactions, unless the activity is illegal. If a transaction presents a breach of the duty of loyalty or prudence, the grantor of a revocable trust may authorize the transaction after full disclosure of the pertinent details. In such cases, before commencing the transaction, the savings association should document that full disclosure has been made and that the grantor authorized the transaction.

Conflicts of Interest in Regards to Mutual Fund Investments

More and more savings associations are receiving financial compensation or incentives from mutual funds for various services rendered. The mutual fund may (directly or indirectly) pay compensation to a savings association, or its affiliates, for investment advisory or other services. It may also pay compensation tied to the amount the savings association has invested in the mutual fund. With regard to mutual funds that are sponsored or managed by the savings association (proprietary mutual funds), the institution may receive compensation for services rendered to the mutual funds as well as indirect financial benefits resulting from the increased volume of investments in the funds.

The decision by the savings association to invest discretionary fiduciary assets in proprietary mutual funds presents a conflict of interest due to the direct and indirect financial benefits it receives. Most states have enacted legislation allowing such investments, as well as investments in nonaffiliated mutual funds from which the savings association receives financial benefits. The state laws often address the fees that may be charged to the fiduciary account as a result of the mutual fund investment as well as the fees that may be received by the savings association. State laws may also address the type of disclosure that must be given to beneficiaries of the fiduciary account and may require consent from beneficiaries before such an investment may be made.

Even if state law does not address disclosure of the nature of the conflict or the benefits the savings association is receiving as a result of the transaction, good risk management practices dictate that such disclosure should be made. The institution should inform account beneficiaries of the nature of the conflict and the financial benefits it will receive as a result of the transaction before the transaction takes place.[1]

Savings associations should understand and follow all the state and federal laws governing the investment of fiduciary account assets in mutual funds.[2] They should have well-developed policies and procedures that address how the institution will comply with the requirements of the laws and should develop a risk assessment process for monitoring compliance.

In documenting its determination that investment in a mutual fund from which the savings association is receiving compensation or incentives meets the state prudent man/prudent investor rules, the institution

[1] The term "affected account beneficiaries" is defined as those persons or entities under applicable state law that are entitled to receive trust account statements.

[2] If the savings association is acting as a trustee or other fiduciary for employee benefit accounts, it should be fully aware of all the ERISA restrictions regarding such conflict of interest transactions and meet any applicable Department of Labor (DOL) guidelines. The DOL has issued a prohibited transaction class exemption (PTE 77-4) that permits the investment of employee benefit accounts for which a savings association is a fiduciary in a proprietary mutual fund, provided certain conditions are met. The DOL has also issued several advisory opinion letters (93-12A and 93-13A) that address secondary services provided by a bank to a proprietary mutual fund without a waiver or credit of fees. The DOL has issued several advisory opinion letters on the subject of financial institutions providing services to employee benefit plans that are invested in mutual funds where those mutual funds are paying the financial institutions financial benefits as a result of the employee benefit plan investment. See Advisory Opinion 97-15A and Advisory Opinion 97-16A.

should describe the benefits derived by itself and the fiduciary account. It should include in its investment analysis such factors as historical investment performance and expense ratio comparisons in relation to similar mutual funds, ratings by services such as Morningstar, its familiarity with the mutual fund portfolio and investment manager, the generation of capital gains and losses within the fund, and any other relevant factors.

A savings association should also regularly document its decision to continue to retain specific mutual fund investments for fiduciary accounts. The documentation should include evidence that the investment continues to be appropriate for the individual account. This would include a discussion of the relevant prudence factors, any changes in the investment performance of the mutual fund, changes in fees or other costs charged by the mutual fund, changes in the trust account or the trust beneficiaries, and changes in the economy or overall market conditions.

The savings association may conduct this suitability review in conjunction with the annual review it must perform for all fiduciary accounts for which it has investment discretion. See 12 CFR §550.220.